

**STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE**  
45 Fremont Street, 24th Floor  
San Francisco, California 94105

**NOTICE OF PROPOSED ACTION**

November 21, 2005

Regulation File: RH01015731

**SUBJECT OF PROPOSED RULEMAKING**

The Insurance Commissioner proposes to adopt the regulations described below after considering comments from the public. The Commissioner proposes to adopt California Code of Regulations, Title 10, Chapter 5, Subchapter 3, Article 3, §§ 2303 through 2303.25 (the “Reinsurance Oversight Regulations”).

**AUTHORITY AND REFERENCE**

The proposed regulations will implement, interpret and make specific the provisions of California Insurance Code (“Code”) sections 19, 35, 533, 700, 701, 704, 704.7, 717, 730, 733, 736, 739.10, 900, 922.1, 922.2, 922.3, 922.4, 922.5, 922.6, 922.7, 922.8, 922.9, 923, 924, 925, 925.2, 925.4, 1011, 1011.5, 1031, 1215.5(b)(3), 1215.5(f), 1781.10, and 12921.

Code sections 720, 730, 736, 739.9, 922.8, 923, 924, 1011.5, 1215.8, 1781.12, and 12921 provide the authority for this rulemaking. *CalFarm Insurance Company v. Deukmejian*, (1989) 48 Cal. 3d 805 and 20<sup>th</sup> *Century Insurance Company v. Garamendi*, (1994) 8 Cal. 4<sup>th</sup> 216 also provide authority for this rulemaking.

**PUBLIC HEARING**

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to this regulation, as follows:

**Date and time:**           **January 24, 2006, at 10:00 a.m.**

**Location:**               **Ronald Reagan State Building  
Hearing Room, First Floor  
300 South Spring Street  
Los Angeles, CA 90013**

The hearing will continue on the date noted above until all testimony has been submitted or 4:00 p.m., whichever is earlier. The hearing may be continued to the next day, if not all persons present who desire to testify are able to do so prior to the 4 p.m. close of the hearing on January

24th. If the hearing is continued to January 25<sup>th</sup>, it will commence at 10:00 a.m. and continue until all testimony has been submitted or 2:00 p.m., whichever is earlier.

## **PRESENTATION OF WRITTEN COMMENTS; CONTACT PERSONS**

All persons are invited to submit written comments on the proposed regulations during the public comment period. The public comment period will end at 4:00 p.m. on January 24, 2006. Please direct all written comments to the following contact person:

Arlene Joyce, Senior Staff Counsel  
California Department of Insurance  
45 Fremont Street, 24th Floor  
San Francisco, CA 94105  
Telephone: (415) 538-4424  
E-mail: joycea@insurance.ca.gov

Questions regarding procedure, comments, or the substance of the proposed action should be addressed to the above contact person. If she is unavailable, inquiries may be addressed to the following backup contact person:

George Teekell, Staff Counsel  
California Department of Insurance  
45 Fremont Street, 21st Floor  
San Francisco, CA 94105  
Telephone: (415) 538-4390

## **DEADLINE FOR WRITTEN COMMENTS**

All written materials must be received by the Insurance Commissioner, addressed to one of the contact persons at his or her respective address listed above, no later than 4:00 p.m. on January 24, 2006. Any written materials received after that time will not be considered.

## **COMMENTS TRANSMITTED BY E-MAIL OR FACSIMILE**

The Commissioner will accept written comments transmitted by e-mail provided they are sent to the following e-mail address: joycea@insurance.ca.gov. Comments received by e-mail prior to January 21, 2006, will receive an e-mail confirmation of receipt within 24 hours. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of George Teekell and sent to the following facsimile number: (415) 904-5490. **Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline set forth above for written comments.**

## INFORMATIVE DIGEST

### Summary of Existing Law and Policy Statement Overview

Reinsurance is insurance for insurers. Reinsurance permits an insurer to share the risk it assumes on policies it writes, with one or more other insurers called “reinsurers.” A reinsurance contract permits an insurer (the “direct writer”) to transfer (“cede”) to a reinsurer a portion of the risk of loss arising from the underlying policies, in exchange for a portion of the premium earned on those policies. The direct writer remains directly liable to the policyholders for all losses; the reinsurer’s obligation under the reinsurance contract is to indemnify the direct writer, not the policyholders, for the portion of the risk it has assumed. Insurers and reinsurers often use the services of a licensed entity, known as a “reinsurance intermediary,” to facilitate their reinsurance transactions.

Providing that specified requirements are met, a ceding insurer is allowed to reduce the liabilities to policyholders shown on its financial statements (and also reduce the assets required for support of those liabilities) by the amount of those liabilities ceded to a reinsurer. The liabilities and the supporting assets are transferred to and carried on the books of the reinsurer to cover its share of the loss it has accepted (“assumed”). Regulators are assured that, as between the two companies, there are sufficient assets supporting the liabilities to policyholders.

The proposed regulations set forth the principal requirements of substance and procedure in accounting for reinsurance on insurer financial statements, the general requirements applicable to reinsurance agreements, and related sanctions and oversight. The proposed regulations supersede Bulletin 97-5, “Credit in Accounting and Financial Statements on Account of Reinsurance Ceded,” which was adopted by the Commissioner on December 3, 1997 pursuant to the authority set forth in Code Section 922.8. However, the regulations provide that Bulletin 97-5 continues to apply to certain matters.

In Sections 2303.3 through 2303.11, the proposed regulations carry forward most requirements of Bulletin 97-5, which was based largely on the National Association of Insurance Commissioner’s Model Credit for Reinsurance Regulations (hereafter referred to as the “Model Regulation.”) and was issued to implement Code Sections 922.2, 922.4, 922.5, 922.6, and 922.7. The Commissioner has determined that there is a need for additional and different provisions pertaining to accounting for reinsurance transactions on financial statements, based on his experience with the limitations of Bulletin 97-5 and as the result of developments and disclosures in the reinsurance industry. Additionally, in Sections 2303.12 through 2303.25, the proposed regulations specify requirements for reinsurance transactions and related sanctions and oversight, topics that were not covered in Bulletin 97-5.

Existing law provides that in reviewing the qualifications of an applicant for a license to transact insurance business in California, the Commissioner must consider, among other criteria, the insurer’s reinsurance arrangements. If the Commissioner determines that the reinsurance arrangements are materially deficient, the applicant does not meet licensing requirements and the application is denied. (Code Section 717(d).) Once licensed, an insurer is required to comply

with all requirements of the Code, including maintaining reinsurance arrangements that are not materially deficient. (Code Section 700(c).) The proposed regulations define “materially deficient” reinsurance arrangements, and establish standards and requirements for acceptable reinsurance contracts and arrangements as well as procedures for the Commissioner’s review of specified reinsurance transactions.

Licenses that fail to comply with laws regarding governmental control of the insurer may be subject to a license revocation proceeding. (Code Section 701.) A licensee that fails to carry out its contracts in good faith may be subject to license suspension or a fine in lieu of suspension. (Code Sections 704 and 704.7.) A licensee that does not continue to comply with the requirements for issuance of a license, or which is in a financially hazardous condition, or which enters into a transaction involving substantially its entire business without obtaining the Commissioner’s prior consent, may be subject to a conservation proceeding. (Code Sections 1011 and 1011.5.) The proposed regulations define “governmental control,” “not carrying out its contracts in good faith,” and “substantially its entire business.” The proposed regulations establish penalties in lieu of license suspension, as well as procedures to obtain the Commissioner’s prior consent to reinsurance transactions involving substantially the entire business of a licensee.

A significant part of the proposed regulations concern the proper accounting for reinsurance on insurer statutory financial statements. Such statements are prepared in accordance with statutes designed to conservatively test solvency from the policyholder standpoint. The rules governing statutory accounting are designed to minimize the risk to an insurer’s policyholders and creditors.

Existing law prescribes the requirements licensed insurers must follow in completing and filing financial statements. (Code Section 900, *et seq.*) The financial statements must conform to the requirements of the NAIC Accounting Practices and Procedures Manual and NAIC annual statement blanks and instructions, except where the NAIC rules are inconsistent with California law or have been modified by the Commissioner. (Code Section 923.) Insurers are permitted to take credit for reinsurance on their financial statements if the transaction meets all applicable requirements. The reinsurance agreement must transfer risk of loss to the reinsurer, not only in form but in fact. (Code Section 922.3.) The proposed regulations provide requirements relating to risk transfer.

A reinsurance agreement of a domestic ceding insurer must contain prescribed provisions. (Code Section 922.2.) A “domestic” insurer is an insurer organized pursuant to California law. The proposed regulations clarify and make specific certain of the statutorily required provisions, including provisions that may limit or preclude the use of set-offs by reinsurers to reduce their payments to a liquidator in the event the domestic insurer is liquidated. The reinsurer of a domestic insurer must meet specified criteria to be considered an authorized reinsurer, thus allowing the ceding insurer to claim statement credit for reinsurance. (Code Section 922.4.) The proposed regulations establish requirements and procedures for reinsurers to become authorized. If a reinsurer of a domestic insurer is unauthorized, it must provide acceptable collateral as security for its obligation under the reinsurance agreement. (Code Section 922.5.) The proposed regulations specify requirements for acceptable collateral that are more restrictive than the requirements specified in Bulletin 97-5.

A foreign insurer may claim statement credit for reinsurance if allowed by its home state regulator, unless the Commissioner determines that the condition of the reinsurer or the collateral provided does not meet the standards applicable to California domestic insurers. (Code Section 922.6.) A “foreign” insurer is an insurer organized under the laws of another state and that has been issued a license to transact insurance in California. The proposed regulations permit foreign insurers to claim statement credit for cessions to authorized reinsurers. The proposed regulations also establish procedures for the Commissioner’s discretionary review of a cession to an unauthorized reinsurer to determine whether the reinsurer or the collateral provided meet the standards applicable to California domestic insurers.

Reinsurance intermediaries are subject to examination by the Commissioner. (Code Section 1781.10.) Reinsurance intermediaries often provide services to the parties to a reinsurance agreement, including handling accounting, billing and transfer payments between the parties. All premium payments owed to the reinsurer are sent to the intermediary, which then forwards the payments to the reinsurer. The reinsurer sends all payments for claims to the intermediary, which then forwards the payments to the ceding insurer. In providing these services, billions of dollars in transfer payments are handled annually by intermediaries. Reinsurance intermediary brokers are not required to have independent audits. (Code Section 1781.6(c).) No reinsurance intermediary has ever been examined by a federal or state regulator.

When a reinsurance agreement provides for transfer payments by an intermediary, the proposed regulations require the contract to contain a provision placing the risk of an intermediary’s non-performance on the reinsurer, and permits the Commissioner to condition consent to the transaction on the intermediary having been issued a satisfactory examination report by the Department. The regulation establishes procedures for examinations of intermediaries that request examination.

Existing law permits the Commissioner to examine an insurer whenever he deems it necessary and allows the Commissioner to define the nature, scope and frequency of an examination. (Code Section 730.) The Commissioner is required to collect the costs of examination from the insurer or person examined. (Code Section 736.) The proposed regulations specify various types of limited examinations required of licensed insurers under specified circumstances, including the examination of proposed reinsurance transactions which involve 50% or more of an insurer’s business.

The proposed regulations clarify, interpret and make specific all of the above referenced Code sections and specify requirements and procedures for compliance. The proposed regulations are intended to provide a regulatory framework to assess and ensure the quality of a licensee’s reinsurance arrangements to safeguard its solvency and protect the interests of its policyholders and creditors.

## Effect of Proposed Action

### *§2303.2 Definitions*

The definitions follow common industry and Department of Insurance (“Department”) usage, but certain terms have regulatory effects and their meanings have not previously been defined. Those terms are as follows.

The words "examine" and "examination" are used in Insurance Code Section 730 and they are defined in subdivision (j) as referring to all reviews and examinations undertaken by the Commissioner, "regardless of the location of the review or examination."

The word "liabilities" is defined in subdivision (o) to specify the manner in which it includes or excludes modified coinsurance reserves.

The phrase "material reinsurance agreement" is the threshold for the applicability of various sections of the proposed regulations. The term is defined in subdivision (q) as a reinsurance agreement in which the reinsurance premium or a change in the ceding insurer's liabilities equals or exceeds 5 percent of the ceding insurer's policyholder surplus, as of the preceding December 31<sup>st</sup>. The subdivision states the manner of calculating the threshold in the context of multiple agreements with a reinsurer or with reinsurers within the same insurance group.

Subdivision (r) defines "materially deficient" as used in Code Section 717(d), concerning reinsurance arrangements that do not meet the requirements to hold a license to transact insurance business in California. Materially deficient reinsurance arrangements are those that (1) include one or more material reinsurance agreements for which statement credit is claimed that are not in compliance with the requirements of this article, or (2) result in a policyholder surplus that is not reasonable in relation to the insurer's outstanding liabilities and adequate to its financial needs, or (3) are not satisfactory to the Commissioner on the basis that he is unable to make a determination that the arrangements pose no undue risk to the ceding insurer, its policyholders or its creditors. The proposed regulations specify circumstances in which a ceding insurer's reinsurance arrangements are "materially deficient," thus potentially affecting the insurer's license.

Subdivision (t) defines the term “NAIC Accounting Guidance” as the National Association of Insurance Commissioners’ Accounting Practices and Procedures Manual and its annual statement blanks and instructions, as made applicable to licensed insurers pursuant to Code Section 923.

"Regulatory oversight" is broadly defined in subdivision (v) as the exercise of a regulator's powers to monitor or control the operations of an insurer.

"Volume insurer" is defined in subdivision (z) to limit the universe of foreign insurers to which certain of the proposed regulations pertain. A "volume insurer" is defined as any foreign insurer:

1. Whose direct written premium in California represents 20% or more of its total direct written premium as reported on its most recent annual statement; or

2. Whose direct unpaid losses and unpaid loss adjustment expenses in California represent 20% or more of its total direct unpaid losses and unpaid loss adjustment expenses as reported on its most recent annual statement; or
3. Whose direct written premium in California exceeds \$20 Million as reported on its most recent annual statement, or
4. Which assumes more than 50% of its total premium as reported on its most recent annual statement.

#### *§2303.3 Credit For Reinsurance Ceded To Admitted Insurer*

This section allows domestic and foreign insurers to claim statement credit for cessions to licensed insurers, subject to specified conditions that are not expressly stated in Code Section 922.4 or included in Bulletin 97-5. The conditions include meeting the requirements of either Sections 2303.11 or 2303.12 regarding risk transfer, and the requirements of Section 2303.13 that specifies contract terms necessary to claim statement credit. The section provides that an assuming insurer must notify the Commissioner if it becomes the subject of a regulatory order or oversight as a result of a hazardous financial condition.

#### *§2303.4 Credit for Reinsurance Ceded to Accredited Reinsurer*

This section allows domestic and foreign insurers to claim statement credit for cessions to accredited reinsurers, subject to specified conditions that are not expressly stated in Code Section 922.4 or included in Bulletin 97-5. The conditions include meeting the requirements of either Sections 2303.11 or 2303.12 regarding risk transfer, and the requirements of Section 2303.13 that specifies contract terms necessary to claim statement credit. The section provides that an accredited reinsurer must notify the Commissioner if it becomes the subject of a regulatory order or oversight as a result of a hazardous financial condition.

The section includes requirements not expressly specified in the Code, including the following: quarterly submission of lists of the accredited reinsurer's California ceding insurers, consent to California jurisdiction, designation of an agent for service of process other than the Commissioner, submission of news releases as they are issued, and filing specified documents on or before August 15 of each year for review to determine continuing eligibility. The section clarifies that an accredited reinsurer is not a licensed insurer and may not solicit insurance business in California either directly or through an agent.

#### *§2303.5 Credit for Reinsurance Secured by an Approved U.S. Trust*

This section allows domestic and foreign insurers to claim statement credit for cessions to reinsurers with an Approved U.S. trust, subject to specified conditions that are not expressly stated in Code Section 922.4 or included in Bulletin 97-5. The conditions include meeting the requirements of either Sections 2303.11 or 2303.12 regarding risk transfer, and the requirements of Section 2303.13 that specifies contract terms necessary to claim statement credit.

This section specifies the eligibility requirements for an Approved U.S. Trust. The extensive provisions of this section carry forward identical provisions specified in Bulletin 97-5 to implement Code Section 922.4(c). The section includes requirements not expressly specified in the Code, including the following: submission to the Commissioner copies of all documents submitted by the reinsurer to the commissioner of the oversight state (which has primary regulatory jurisdiction over the trust), submission of a certified copy of the approval of the form of the trust by the oversight state, specification of the types of assets to be deposited in the trust including requirements for a letter of credit, provisions to be included within the trust document including the requirement that the trustee shall be liable for its own negligence, quarterly submission of lists of the reinsurer's California ceding insurers, consent to California jurisdiction and the appointment of an agent for service of process other than the Commissioner, exhaustion of other security prior to presentation of claims against the U.S. Trust, and the requirement that assets equal to liabilities must be on deposit no later than 45 days at the end of a calendar quarter.

#### *§2303.6 Credit for Reinsurance Required by Law*

The section defines "jurisdiction" to clarify that term's use in Insurance Code Section 922.4(d) as meaning a state, district or territory of the United States.

#### *§2303.7 Credit for Reinsurance Secured by a Single Beneficiary Trust*

This section states the requirements for a domestic insurer to obtain statement credit for a cession secured by a single beneficiary trust as permitted by Code Section 922.5(a)(2). That code section specifies that the trust must be acceptable to the Commissioner, and states the qualifications of a trustee and permitted assets to be held in the trust. The section generally carries forward the provisions of Bulletin 97-5, modifies a provision of Bulletin 97-5, and contains certain new requirements.

The sections carried forward from Bulletin 97-5 pertain to: (i) definitions of trust terminology (subdivision (b)); (ii) creation of the trust, location of trust assets, operation of the trust, parties to the trust, withdrawal from the trust, trustee's duties, and termination notice (subdivision (c)); optional trust provisions (trustee resignation, asset valuation, trustee's authority to invest, transfer of assets, etc.) (subdivision (d)); required terms for a reinsurance agreement that provides for the trust (subdivision (e)); and optional terms for a reinsurance agreement that provides for the trust (subdivision (f)).

A provision modified from Bulletin 97-5 moves a conditional use provision which limits a beneficiary's use of trust assets from an optional provision in the trust to an optional provision in the reinsurance agreement (paragraphs (f)(2) and (f)(3)). A requirement established by Section 2303.7 that is not contained in Bulletin 97-5 nor expressly stated in Code Section 922.5(2) is that the cession must comply with Sections 2303.11 through 2303.13 of the regulations relating to risk transfer and required contract provisions for statement credit.

### *§2303.8 Credit for Reinsurance Secured by Letter of Credit*

This section states the requirements a domestic insurer must meet in order to obtain statement credit for a cession secured by a letter of credit as permitted by Code Section 922.5(b). That code section specifies only that the letter must be satisfactory to the Commissioner and be clean, irrevocable and unconditional and issued by a bank meeting specified qualifications. This section carries forward certain requirements of Bulletin 97-5, modifies some requirements and contains new requirements. A requirement established by Section 2303.7 that is not contained in Bulletin 97-5 nor expressly stated in Code Section 922.5(2) is that the cession must comply with Sections 2303.11 through 2303.13 of the regulations relating to risk transfer and required contract provisions for statement credit. Bulletin 97-5 required a letter of credit to state that it is "clean;" this section of the proposed regulations (paragraph (c)(2)) specifies the characteristics of a letter of credit that make it "clean" and therefore, the requirement that it state that it is "clean" has been eliminated. As in the Bulletin, the letter of credit must state that it is "irrevocable and unconditional" (subdivision (c)), and it must be "evergreen" (paragraph (c)(6)). Subdivision (c) adds a requirement that the amount of the letter of credit cannot be modified without the prior written consent of its beneficiary, except in the case where the modification increases the amount of the credit (subparagraph (c)(2)(B)).

Paragraphs (c)(3) - (5) add requirements that the only requirement for drawing against the letter of credit is the presentation of a sight draft, the letter of credit must contain issue and expiration dates, and its term cannot be shorter than one year. Paragraph (c)(7) is a new provision that requires the letter to require California jurisdiction (unless subpart (d) applies). Paragraph (c)(8) provides that the letter of credit must specify certain addresses, including the address where the letter of credit is payable. Paragraphs (c)(9) and (10) require a 60 day period for drawing against a letter of credit in the event the letter would otherwise expire during a period that the business of the issuing bank or the insurer beneficiary is interrupted by specified events. Paragraph (c)(11) requires identifying information on each page of the letter of credit and paragraph (c)(12) specifies other identifying information that may appear.

Subdivision (d), which is not contained in Bulletin 97-5, provides that the Commissioner may permit statement credit for a transaction secured by a letter of credit that is subject to the laws of a state other than California if that state's laws are substantially similar to California's laws and if it is reasonably necessary to expand the availability of letters of credit to California domiciled insurers.

Subdivision (e) designates a letter of credit form that is acceptable to the Commissioner (the form set forth in Section 2303.25(d)) and provides that parties to a reinsurance transaction may submit a letter of credit form to the Commissioner for a determination that it complies with this section.

Subdivision (f), which does not have a counterpart in Bulletin 97-5, requires the reinsurer to consent to California jurisdiction and to appoint an agent for service of process (or to stipulate that if no agent is appointed, then the Commissioner shall be its agent.).

Subdivision (g) carries forward provisions of Bulletin 97-5 specifying provisions that may be contained in a reinsurance agreement regarding the posting of a letter of credit and the terms of a letter of credit regarding the timing of draws against the letter and the purpose of such draws.

Subdivision (h) pertains to transactions between foreign insurers and unauthorized reinsurers; it has no counterpart in Bulletin 97-5. The subdivision provides that statement credit may be taken for reinsurance ceded by a foreign insurer to an unauthorized reinsurer if the transaction is secured by a letter of credit and if the ceding insurer's state of domicile allows statement credit for the transaction. The subdivision provides that such credit will not be permitted, however, if the Commissioner determines that the transaction does not meet, in substance, the requirements of this section.

#### *§2303.9 Credit for Reinsurance Secured by Funds Withheld*

Section 2303.9 pertains to reinsurance transactions which are "secured" by a reinsurance agreement providing for funds withheld by the ceding insurer, and it carries forward the provisions of Bulletin 97-5 implementing Code Section 922.5(1). It includes a definition of "unencumbered funds withheld" that is not included in Code Section 922.5(1); specifically it provides that funds held in an "escrow account" do not meet the requirements of the Code that the funds must be held in the name of and under the exclusive control of the ceding insurer.

A requirement established by Section 2303.7 that is not contained in Bulletin 97-5 nor expressly stated in Code Section 922.5(2) is that the cession must comply with Sections 2303.11 through 2303.13 of the regulations relating to risk transfer and required contract provisions for statement credit.

Subdivision (c) pertains to transactions between foreign insurers and unauthorized reinsurers; it has no counterpart in Bulletin 97-5. The subdivision provides that statement credit may be taken for reinsurance ceded by a foreign insurer to an unauthorized reinsurer if the transaction is secured by a funds held agreement and if the ceding insurer's state of domicile allows statement credit for the transaction. The subdivision provides that such credit will not be permitted, however, if the Commissioner determines that the transaction does not meet, in substance, the requirements of this section.

#### *§2303.10 Credit for Reinsurance of Foreign Insurers*

This section applies to foreign insurers; it modifies the corresponding section in Bulletin 97-5, which implemented Code Section 922.6, and includes several new requirements.

Subdivision (a) clarifies that foreign insurers are required to comply with all California financial statement accounting requirements, unless the requirement specifically applies only to California domiciled insurers.

Subdivision (c) provides that where credit is claimed on the basis that an unauthorized reinsurer is accredited or licensed in the foreign insurer's state of domicile, the unauthorized reinsurer must in substance meet California licensing or accreditation standards. The subdivision also

provides that where credit is claimed on the basis of security in the form of a trust agreement, letter of credit, or funds held agreement, the security must, in substance, meet the standards for like security in California.

Subdivisions (d) and (e) provide that upon the request of the Commissioner, the foreign insurer shall provide information concerning the unauthorized reinsurer for examination to assess the credit taken, and shall pay the cost of examination of the documents submitted.

#### *§2303.11 Transfer of Risk – Life & Disability*

Code Section 922.3 precludes credit for reinsurance unless the agreement transfers insurance risk to the reinsurer. However, the Code does not provide specific guidance to determine risk transfer. Code Section 923 requires licensed insurers to follow the requirements of the NAIC Accounting Guidance, to the extent they are not inconsistent with California law or modified by the Commissioner. The NAIC Accounting Guidance contains model regulation language for life and disability risk transfer in Appendix A-791, which was generally followed in Bulletin 97-5 and generally carried forward in this section. Variances from Appendix A-791 are noted below.

Subdivision (b) adds language that clarifies which YRT reinsurance agreements are exempt from the risk transfer requirements, based on the amount of reserve credit being taken by the ceding company.

Paragraph (c)(2) prohibits the ceding insurer from suffering depletion in assets or surplus at the reinsurer's option, at a specified time scheduled in the reinsurance agreement, or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer.

Paragraph (c)(4) provides that a contract for which statement credit is claimed may not allow the reinsurer to unilaterally terminate the agreement or require the ceding insurer to automatically recapture all or part of the reinsurance ceded.

Paragraph (c)(8) provides that a contract for which statement credit is claimed must require payment in cash by the reinsurer of amounts receivable within thirty days of the settlement date.

Subdivision (d) provides that the Commissioner may allow statement credit for the agreement, notwithstanding that the agreement does not meet the requirements of subdivision (c) of this section, as the Commissioner considers appropriate, and clarifies that any such allowance by the Commissioner shall not be deemed approval of the reinsurance treaty nor shall it be considered an indication that reinsurance credit may be allowed for other similar treaties.

Subdivision (e) requires insurers to file copies of agreements and financial impact information concerning reinsurance of business issued prior to the effective year of the agreement and specifies requirements for financial reporting.

Subdivision (g) clarifies that the appointed actuary should consider the insurance company's reinsurance agreements in his/her actuarial opinion of the company's reserve liability, as

reported in the financial statement, and requires the actuary to maintain adequate documentation to support the reserve credit taken.

Subdivision (i) provides that all contracts between the ceding insurer, the reinsurer, and their affiliates, may, in the Commissioner's discretion, be reviewed in the determination of risk transfer.

#### *§2303.12 Transfer of Risk – Property & Casualty*

Code Section 922.3 precludes credit for reinsurance unless the agreement transfers insurance risk to the reinsurer. However, the Code does not provide specific guidance to determine risk transfer. Code Section 923 requires licensed insurers to follow the requirements of the NAIC Accounting Guidance, to the extent they are not inconsistent with California law or modified by the Commissioner.

Subdivision (a) provides that transfer of risk shall be determined by application of the NAIC Accounting Guidance, in a manner consistent with the following principles:

1. A reinsurance agreement must transfer an insurance risk for which there is a reasonable possibility of a significant loss to the reinsurer.
2. Recoveries due to the ceding insurer under a reinsurance agreement must be available without delay, in a manner consistent with the orderly payment of incurred policy or contract obligations by the ceding insurer.

Subdivision (b) provides that in the review of a reinsurance agreement to evaluate transfer of risk, all contracts between the ceding insurer, the reinsurer, and their respective affiliates, may, in the Commissioner's discretion, be reviewed to determine whether any provision may (1) limit the amount of insurance risk to which the reinsurer is subject under the agreement, or (2) delay the timely reimbursement of claims by the reinsurer.

#### *§2303.13 Contract Requirements for Statement Credit*

Subdivision (a) states requirements for the reinsurance agreements of domestic insurers and volume insurers (as defined in 2303.2(z)) where statement credit is claimed.

Paragraph (a)(1) requires that a reinsurance agreement must expressly disclose, within the agreement or in an exhibit incorporated by reference, every separate contract which would under any circumstances reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the agreement.

Paragraph (a)(2) provides that the agreement must also contain an integration clause stating that the agreement constitutes the entire agreement between the parties and that there are no other

agreements pertaining to the business, except as has been expressly disclosed within the agreement.

Paragraph (a)(3) requires that a report of premium and losses be prepared no less frequently than quarterly, and requires payment by the reinsurer within 30 days of the date of the report.

Paragraph (a)(4) specifies requirements that apply to reinsurance of property/casualty risks regarding availability of payment without delay, prohibition on guaranty of profit, reporting consistent with NAIC guidelines, and retroactive reinsurance.

Paragraph (a)(5) allows the Commissioner to permit or require an NAIC Accounting Guidance requirement rather than a corresponding requirement in the regulations, by notice to licensees.

Subdivision (b) is applicable only to the reinsurance agreements of domestic insurers where statement credit is claimed. Paragraph (b)(1) specifies the essential elements to be included within an acceptable insolvency clause.

Paragraph (b)(2) specifies an express statement to be included within the insolvency clause: “Notwithstanding any other provision of this agreement, in the event of the insolvency of the ceding insurer, no provision may reduce the payment to the conservator, liquidator or statutory successor required of the reinsurer by the insolvency clause.”

Paragraph (b)(3) clarifies that additional provisions from the Code may be included in the insolvency clause. Paragraph (b)(4) defines a “statutory insolvency clause.” Paragraph (b)(5) limits the scope of an acceptable set-off clause. Paragraph (b)(6) limits the scope of an acceptable arbitration clause.

Subdivision (c) defines the term “the portion of any risk or obligation assumed by the reinsurer” which is required to be included in the insolvency clause as meaning all the risk assumed by the reinsurer under the reinsurance agreement, without application of a set-off, and provides that “set-off” includes recoupment, netting, offset, or any term that would have the effect of reducing an amount otherwise owed.

Subdivision (d) provides that credit for a reinsurance agreement not subject to the requirements of this section shall be allowed if credit is permitted by the insurer’s state of domicile.

Subdivision (e) provides that where the agreement involves multiple ceding insurers that credit may be taken notwithstanding non-compliance with this subdivision if (1) the agreement is not a material reinsurance agreement (as defined in 2303.2(q)) and the agreement meets NAIC Accounting Guidance requirements, or (2) the Commissioner has provided written consent.

#### *§2303.14 Form of Agreements*

Subdivision (a) applies to the reinsurance agreements of domestic insurers for which statement credit is claimed, and specifies that non-complying agreements are deficient and may be determined materially deficient in a license revocation proceeding initiated pursuant to Code

Section 701. Paragraph (a)(1) requires the agreement to include an insolvency provision meeting the requirements of Section 2303.13(b)(1) and (2). Paragraph (a)(2) limits the scope of an acceptable set-off provision. Paragraph (a)(3) limits the scope of an extra contractual obligation provision. Paragraph (a)(4) requires a jurisdiction provision specifying California jurisdiction. Paragraph (a)(5) requires a choice of law provision specifying California law. Paragraph (a)(6) requires an arbitration provision to specify that arbitration will be held in California and to comply with the requirements of Section 2303.13(b)(6). Paragraph (a)(7) requires a material reinsurance agreement to include the provisions in subdivision (b)(2) through (b)(6) of this section.

Subdivision (b) applies to the material reinsurance agreements of “volume insurers” for which statement credit is claimed, and specifies that non-complying agreements are deficient and may be determined materially deficient in a license revocation proceeding initiated pursuant to Code Section 701. Paragraph (b)(1) states requirements for an insolvency clause. Paragraph (b)(2) requires the agreement to include the disclosure requirements in Section 2303.13(a). Paragraph (b)(3) requires the agreement to provide that any change or modification to an agreement shall be made only by written amendment signed by all parties. Paragraph (b)(4) limits the scope of an early termination provision, and requires notice of not less than 60 days if sent by the reinsurer. Paragraph (b)(5) requires express language transferring the risk of non-performance of a reinsurance intermediary to the reinsurer if the agreement permits the intermediary to transmit payments between the parties.

Paragraph (b)(6) requires the agreement to provide that, after the commencement of arbitration or litigation of a dispute concerning sums the ceding insurer claims due, if the aggregate amount in dispute is at a specified level, the reinsurer shall establish an escrow account to hold all unpaid sums accrued and accruing pending resolution of the dispute. The paragraph includes required provisions for the reinsurance agreement and the escrow agreement, and provides that the required terms may be incorporated in the reinsurance agreement by reference. Subdivision (c) provides acceptable text to incorporate the escrow provisions into the agreement. Subdivision (d) specifies that the deposit of funds into an escrow account as required by this section is an interim remedy and may not be used as a defense in a proceeding brought against the reinsurer under Code Section 704.

Subdivision (e) specifies that the form of reinsurance agreements that are not subject to the requirements of subdivisions (a) or (b) of this section shall conform to the requirements of the NAIC Accounting Guidance. Subdivision (f) provides that reinsurance agreements may contain additional provisions not inconsistent with the requirements of this article or the NAIC Accounting Guidance. Subdivision (g) provides that a reinsurance agreement not in compliance with the requirements of this section is not materially deficient if the Commissioner has provided written consent to financial statement credit for the cession pursuant to the provisions of Section 2303.13(e) of this article.

#### *§2303.15 Oversight of Reinsurance Transactions*

Subdivision (a) provides that the policyholder surplus of a licensed insurer shall at all times be reasonable in relation to the insurer’s outstanding liabilities and adequate to its financial needs,

as determined by applying the factors set forth in Code Section 1215.5(f). Subdivision (b) provides definitions of terms used in this section. Subdivision (c) defines the phrase, “substantially its entire property or business” used in Code Section 1011, a statute within an article of the Code that governs insurer receiverships. It provides that a sale, cession, assumption or purchase that equals or exceeds either 75% of an insurer’s total premium or 75% of its total liabilities, calculated before the subject transaction, shall constitute “substantially its entire property or business” under Code Section 1011(c). Subdivision (d) specifies that domestic insurers and volume insurers are required to obtain the Commissioner’s prior consent to transactions within the scope of subdivision (c).

Subdivision (e) provides that insurers not subject to the filing requirement of subdivision (d) of this section need obtain the Commissioner’s prior consent to a transaction within the scope of subdivision (c) only when directed to do so by notice from the Commissioner, and also that they may voluntarily seek the Commissioner’s prior consent to the transaction.

Subdivision (f) provides standards for consent to transactions within the scope of subdivision (c). Initially the subdivision provides that consent shall be based upon demonstrated business necessity. The subdivision requires that licensed insurers shall maintain a significant level of risk, and that risk may be both direct and assumed. The subdivision provides that except for cessions to inter-company pools, consent to cessions of more than 90% of an insurer’s total premium on prospective business shall be given only for agreements with a limited contract term, generally not to exceed one year. The 90% calculation shall be applied to total premium, before the subject transaction. This requirement permits consent to a cession greater than 90% where the contract term is limited, if business necessity demonstrates the need. Inter-company pools are excepted from the 10% retention requirement.

Subdivision (g) states requirements applicable to inter-company pools. The agreement must provide for a retrocession to the ceding insurer of an amount equal to not less than 10% of its new direct business. The subdivision specifies that the Commissioner will not consent to an inter-company pool agreement unless either (1) the ceding insurer maintains surplus at a level sufficient to cover its direct writings, or (2) the agreement meets the requirements of subdivision (j) of this section that prescribes contract provisions for the conditional provision of collateral by the lead company in the pool should its financial strength diminish during the term of the agreement or should a regulator deny credit for the cession.

Subdivision (h) requires the Commissioner’s prior consent to an agreement with one party, where a domestic insurer or a volume insurer cedes or assumes an amount that is equal to or greater than 50% of its total business, but less than the 75% amount subject to the requirements of Code Section 1011(c) and subdivisions (c) and (d) of this section, to make a determination whether the agreement is materially deficient under Code Section 717(d).

Subdivision (i) provides that a filing made pursuant to subdivisions (d) or (e) of this section shall satisfy any filing requirements of Code Sections 1011.5 and 1215.5(b)(3).

Subdivision (j) specifies additional conditions to be met for the Commissioner’s consent to a reinsurance transaction when his consent is required by this article or by Code Section

1215.5(b)(3). The subject transactions would be those where a domestic insurer or volume insurer cedes 50% or more of its business, or where a licensee cedes business to an affiliate. The subdivision provides that where the loss of statement credit for reinsurance ceded to a licensed or accredited reinsurer would cause a significant adverse impact upon a domestic or volume insurer, the Commissioner may condition consent to the transaction upon inclusion within the reinsurance agreement of a provision requiring the reinsurer to provide security for the cession should its financial strength diminish during the term of the contract, or should a regulator deny credit for the cession.

Subdivision (k) states requirements for agreements where the contract is a material reinsurance agreement, the ceding insurer is either a domestic insurer or a volume insurer, and the agreement provides for transmission of payments between the parties through a reinsurance intermediary. The subdivision provides that the Commissioner may condition consent to the subject transaction upon the intermediary having been issued a satisfactory examination report by the Department within the prior three years.

Subdivision (l) provides that if the parties desire to amend an agreement after the Commissioner has provided consent, the parties shall submit a copy of the proposed amendment to the Department at least 30 days prior to its execution for a determination of whether a new application for consent will be required. The subdivision requires that notice of the proposed amendment shall include an explanation of the reason for the change, and specifies the manner of submitting the notice.

Subdivision (m) is applicable to licensees that have been sold as a corporate shell, or when a sale of the insurer or other circumstance results in a significant change in the insurer's operations so that all or a majority of the documents previously submitted to the Department by the insurer concerning its operations are no longer valid. The licensee is required to submit the same documents required for an initial application for a Certificate of Authority for a determination that its reinsurance arrangements are not materially deficient and that it meets all licensing requirements.

Subdivision (n) prescribes the form of formal commitments made by licensees.

Subdivision (o) clarifies that the formal report of examination required by Code Section 734.1, which are issued following once every five year formal examinations, will not be routinely issued for the limited examinations required or permitted by this article, or the limited examinations routinely performed as a function of Department oversight. The subdivision permits the insurer to request a formal written report of examination, with an acknowledgement that preparation of the report may require further examination of the insurer.

Subdivision (p) provides that the Commissioner's consent is conditioned upon the truth and veracity of the documents and information submitted by or on behalf of the licensed insurer making the request. The subdivision states the consequences for submitting documents or information that are materially false or misleading, or failing to disclose material information, as including voiding of consent and revocation of a Certificate of Authority.

### *§2303.16 Attestation Requirements*

Commencing with the annual statement for 2005, each property and casualty insurer is required to file with its annual statement a form designated as "Supp 20-1," titled "Reinsurance Attestation Supplement." This section requires that for each separate agreement disclosed in the attestation form, the insurer shall provide a summary description of the separate agreement, including the parties, the date of execution and the inception date, and a summary description of the agreement to which the separate agreement relates, including the parties, the date of execution and the inception date. The section provides that the additional information may be included within the required attestation form or as an attachment thereto.

### *§2303.17 Reinsurance Intermediaries*

This section establishes the standards and procedures for the examination of a licensed reinsurance intermediary as permitted in Code Section 1781.10.

Subdivision (a) provides that an application for examination of an intermediary may be made upon the request of the intermediary, or upon the request of a licensed insurer with the written consent of the intermediary. The subdivision specifies the documents to be included with the application, including copies of the financial reports provided by the intermediary to its clients in the three years prior to the application; copies of any audits performed in the three years prior to the application, copies of specified financial reports if the intermediary is not independently audited; a report of funds held in fiduciary accounts; a description of fidelity bonds and errors and omission policies; and other information as may be requested by the Commissioner.

Subdivision (b) provides that each financial report submitted pursuant to this section shall be certified by an officer of the intermediary as being a true copy of the original, and shall contain a statement signed by the intermediary's chief financial officer under penalty of perjury attesting to the veracity of the report.

Subdivision (c) provides that the Commissioner shall examine the business and affairs of the intermediary to determine its compliance with applicable provisions of the California Insurance Code and its ability to fulfill its obligations.

Subdivision (d) specifies the procedures for issuance of the examination report, which follow similar requirements applicable to the issuance of examination reports for insurers.

Subdivision (e) specifies that the Commissioner shall not commence examination of the intermediary until receipt of a written commitment from the applicant, satisfactory to the Commissioner, that the applicant shall promptly pay all costs of the examination.

Subdivision (f) provides that a request for an examination of a reinsurance intermediary shall be made following the procedures set forth in Section 2303.22(i) of this article.

Subdivision (g) requires licensed intermediaries to annually file with the Department a copy of the financial statements they provide to their clients pursuant to the requirements of Code Sections 1781.6(c) and 1781.9(b).

Subdivision (h) clarifies that the Commissioner may examine an intermediary whenever he deems necessary.

#### *§2303.18 Commissioner's Discretion*

This section provides that the Commissioner may exercise discretion in requiring strict compliance with the requirements of this article, where the Commissioner determines that (1) the variance is not material, (2) the true financial condition of the insurer may be elicited from analysis of the financial statements and other public documents as may be filed, and (3) compliance would cause undue hardship to the insurer.

#### *§ 2303.19 Denial of Statement Credit And Non-Admission of Assets*

Subdivision (a) provides that credit on financial statements for reinsurance ceded shall be denied if the applicable requirements of Sections 2303.3 through 2303.13 of this article have not been met, by non-admission of recoverables on paid losses, disallowance of recoverables on unpaid losses, or a requirement to use deposit accounting for the cession.

Subdivision (b) provides that reinsurance recoverables that are due more than 90 days from a reinsurer to a domestic insurer on paid losses or paid loss adjustment expenses may, in the Commissioner's discretion, be deemed non-admitted assets. The subdivision also provides that a domestic insurer may follow the NAIC Accounting Guidance when reporting reinsurance recoverables due more than 90 days on its financial statements, unless the Commissioner expressly requires the statements to reflect the subject recoverables as non-admitted assets.

Subdivision (c) provides that upon a determination that credit for reinsurance ceded shall not be permitted or an asset is deemed non-admitted, the Commissioner shall issue a finding in the form of a written explanation to the ceding insurer setting forth the reasons for the determination. The determination may be appealed to the Chief of the Financial Surveillance Branch or to the successor position after a reorganization of the Department, in a manner consistent with making a request for a permitted accounting practice.

Subdivision (d) provides that denial of credits on financial statements for reinsurance ceded pursuant to subdivisions (a) and (b) of this section shall not be construed to be the only adjustments for reinsurance contemplated under the California Insurance Code. To the extent that the NAIC Accounting Guidance prescribes additional reductions in credits for reinsurance or additional liability provisions for reinsurance, the NAIC Accounting Guidance shall be followed.

#### *§2303.20 Sanctions For Non-Payment of Reinsurance*

Subdivision (a) specifies that the failure or refusal of a reinsurer to make payments to a ceding insurer of the amount shown on a settlement report as the reinsurer's share of losses and loss

adjustment expenses shall constitute not carrying out a contract in good faith under Code Section 704 if (1) the reinsurer's response to the settlement report does not establish that it had a reasonable basis for its decision, or (2) the reinsurer's investigation of the ceding insurer's claim for payment was not conducted in good faith.

Subdivision (b) defines "settlement report" and "timely payment", which are key terms used in the section.

Subdivision (c) provides that for purposes of calculating the fine permitted by Code Section 704.7 (up to \$55,000), each failure by a reinsurer to make timely payment of the amount stated in a settlement report shall constitute a separate violation if either of the conditions specified in subdivision (a) of this section exists with regard to such unpaid amount.

#### *§2303.21 Insurer Default For Failure To Comply*

Subdivision (a) of this section provides that as used in Code Section 701, "governmental control" includes the requirements placed upon licensed insurers by this article. Subdivision (b) of this section provides that a violation by a licensed insurer of any requirement of this article shall constitute a failure to comply with the laws of this State regarding governmental control.

#### *§2303.22 Filing Requirements*

Subdivision (a) provides that all costs and expenses incurred by the Department in connection with the review of an application, request or filing made under this article by or on behalf of an insurer or reinsurance intermediary in excess of any deposit paid shall be billed to the insurer or reinsurance intermediary making the application, request or filing. This subdivision also provides that the Commissioner shall maintain a schedule of the deposits required under this article on the Department's website and, after 90 days notice provided on the website schedule, may revise the deposit amounts as necessary to substantially cover the expected costs of review.

Subdivision (b) provides that as used in Code Section 924 which assesses late filing fees, the term "statements or stipulations" shall include all filings required by this article and the filings required by Code Section 1011.5.

The remaining subdivisions of this section specify the deposit amounts and filing instructions for the various applications required by this article.

#### *§ 2303.23 Severability*

This subdivision provides that if any provision of this article, or the application of a provision to any person or circumstance, shall be held invalid, the remainder of the article, and the application of the provision to persons or circumstances other than those to which it is held invalid, shall not be affected.

#### *§2303.24 Effective Date*

Subdivision (a) provides that Section 2303 through Section 2303.25 of this article shall become effective on July 1, 2006, or the 60th day following the day those sections are filed with the Secretary of State, whichever is later (the "Effective Date"). The subdivision also provides that Section 2303.15(k) (conditioning consent to a transaction on the availability of an intermediary examination) becomes effective one year after the date when all other sections of the regulations become effective.

Subdivision (b) provides that no licensee may claim reserve credit for any reinsurance agreement entered into or renewed on or after the Effective Date unless the agreement and the security provided therefor conform to the requirements of this article. Except as specifically provided, the regulations will not apply to reinsurance agreements that are in effect prior to the Effective Date. The subdivision also provides that no licensee may claim reserve credit for any material reinsurance agreement, as defined in Section 2303.2(q), that is materially amended on or after the Effective Date unless the agreement and the security provided therefor conform to the requirements of this article.

Subdivision (c) provides that licensees shall follow the requirements of Bulletin 97-5, issued pursuant to Code Section 922.8, until the Effective Date. On and after the Effective Date, all reinsurance agreements and security that are not made subject to the requirements of this article pursuant to subdivision (b) of this section shall remain subject to the requirements of Bulletin 97-5. The subdivision provides that Bulletin 97-5 is incorporated in the regulations by reference for that limited purpose.

Subdivision (d) provides that licensees shall continue to conform to the requirements of the NAIC Accounting Guidance, to the extent that those requirements do not conflict with applicable requirements of the Code and Bulletin 97-5, or, after the Effective Date, with this article.

#### *§2303.25 Approved Forms*

This section provides forms that are required or permitted by the regulations. The Certificate of Assuming Insurer Form AR-1 as published in this section is required under Section 2303.4 and 2303.5 of this article. The Designation of Agent for Service of Process and Consent to Jurisdiction Form AR-2 as published in this section is a form acceptable to the Commissioner under the requirements of Sections 2303.4, 2303.5, 2303.7, and 2303.8 of this article. The Letter of Credit for Reinsurance Form AR-3 as published in this section is a form acceptable to the commissioner for the purpose of securing ceded reinsurance under Section 2303.8 of this article.

#### **Document Incorporated by Reference**

The following document has been incorporated by reference into the proposed regulations:

California Department of Insurance Bulletin 97-5, dated December 3, 1997.

#### **MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS**

The proposed regulations do not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

### **COST OR SAVINGS TO STATE/LOCAL AGENCY OR SCHOOL DISTRICT OR IN FEDERAL FUNDING**

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

### **ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE**

The Commissioner has made an initial determination that the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. Affected businesses are licensed insurers and licensed reinsurance intermediaries.

With respect to a licensed insurer, the regulations include requirements that may reduce a licensee's policyholder surplus by the denial of credit for reinsurance, which may restrict its writing of new business and perhaps negatively affect its financial strength rating; these consequences in turn could reduce profitability, increase costs and impair the insurer's ability to compete. The regulations include requirements that specified reinsurance contracts and supporting collateral of domestic insurers and many foreign insurers must include specific provisions, which may increase associated costs or reduce the universe of reinsurers willing to enter contracts or provide collateral with such terms.

The regulations require domestic ceding insurers to include provisions in their reinsurance agreements that may limit or preclude a reinsurer's ability to apply a set-off to reduce its payment obligations to the liquidator in a liquidation of the ceding insurer. The set-off limitations may reduce the universe of reinsurers willing to enter contracts with such terms, and may result in an increase in the cost of reinsurance to some domestic ceding insurers, increasing the cost of their products and adversely impacting their ability to compete.

The proposed regulations may require domestic insurers and certain foreign insurers to maintain a greater level of surplus and insurance risk than they maintain at present in reinsurance transactions among affiliates where most of the risk and assets are presently transferred to a lead insurer in the group. Requiring a greater retention of assets by affiliates may result in lower investment income for the group.

The Commissioner has carefully considered the adverse economic impact on licensed insurers that may occur by adoption of the proposed regulations, and has no evidence to demonstrate that the adverse economic impact will be significant. The Commissioner has determined that the

benefit to be gained by the proposed regulations in safeguarding the solvency of licensed insurers and protecting the interests of their policyholders and creditors outweighs the likely adverse economic impact.

As described below, licensed reinsurance intermediaries may for the first time be required to undergo examination by the Department, at a cost to them that is estimated at \$51,000 every three years.

The Commissioner has not considered proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

#### **POTENTIAL COST IMPACT ON PRIVATE PERSONS OR ENTITIES/BUSINESSES**

With respect to licensed insurers, additional costs will include training of staff, revising contract forms to include new provisions, and perhaps consulting fees. Costs for reinsurance may increase. The additional costs are not known.

With respect to a licensed reinsurance intermediary, certain intermediaries will undergo financial examination by the Department. The cost of examination will be borne by the intermediary, and is estimated to be approximately \$51,000. The Commissioner estimates that approximately 10 intermediaries will require examination, which will be performed in the year following the effective date of the regulations. An examination of the intermediary would be performed every three years. A licensed intermediary may be considered a small business.

The Commissioner has determined there is no reasonable alternative to the presently proposed regulations with respect to examination of intermediaries. Licensed reinsurance intermediary brokers are presently not independently audited. An independent examination by a Certified Public Account would be far more expensive to the intermediary than the proposed examination by the Department. No other state or federal regulator examines reinsurance intermediaries, notwithstanding that the intermediaries examined under the regulations handle billions of dollars annually in transfer payments between insurers and reinsurers.

For certain insurers a savings of \$5,400.00 could result from the adoption of the regulations. Currently, an insurer that transfers or assumes substantially all of its business must apply for the commissioner's prior consent. The fee charged by the Department for these applications is

\$5,400.00. The proposed regulations would reduce the number of such insurers that would be required to seek such consent, by exempting from this requirement foreign insurers whose volume of California business is sufficiently low. For this reason, low-volume foreign insurers transferring or assuming substantially all their business would no longer be required to pay the \$5,400.00 fee. However, such insurers are not representative of the businesses that would be subject to the proposed regulations, and the annual cost saving is not known.

## **FINDING OF NECESSITY**

The Commissioner finds that it is necessary for the welfare of the people of the state that the regulations apply to businesses.

## **EFFECT ON JOBS AND BUSINESSES IN CALIFORNIA**

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of new businesses, and the expansion of businesses currently operating in the state. The Commissioner estimates that the proposed regulations may create employment opportunities for ten or less consultants to provide advice and staff training with respect to compliance. Interested parties are invited to comment on this issue.

## **IMPACT ON HOUSING COSTS**

The matters proposed herein will have no significant effect on housing costs.

## **ALTERNATIVES**

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are imposed or would be as effective and less burdensome to affected private persons than the proposed regulations. The Commissioner invites public comment on alternatives to the regulations.

## **IMPACT ON SMALL BUSINESS**

The Commissioner has determined that the proposed regulations will affect small business, to the extent a licensed reinsurance intermediary may qualify as a small business. Pursuant to Government Code section 11342.610, subdivision (b), paragraph (2), insurers are not small businesses. All reinsurers are necessarily insurers.

## **COMPARABLE FEDERAL LAW**

There are no existing federal regulations or statutes comparable to the proposed regulations.

## **TEXT OF REGULATIONS AND INITIAL STATEMENT OF REASONS**

The Department has prepared an initial statement of reasons that sets forth the reasons for the proposed regulations. The initial statement of reasons and the text of the proposed regulations are available on the Department's website and may be accessed as explained below.

Upon request, the initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above. Upon request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Requests for the final statement of reasons should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the statement of reasons, the information upon which the proposed action is based, and any supplemental information, including any reports, documentation and other materials related to the proposed action that is contained in the rulemaking file, is available for inspection and copying at 45 Fremont Street, 21st Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday.

## **AUTOMATIC MAILING**

A copy of this notice, including the informative digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Insurance Commissioner's mailing list.

## **WEBSITE POSTINGS**

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Find, near at the top of the leftmost column, the pull down menu under the heading "Quick Links." Select the "Legal Information" link. On the "Legal Information" page, click on the "Proposed Regulations" link. When the "Search or Browse for Documents for Proposed Regulations" screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To search, enter "RH01015731" (the Department's regulation file number for these regulations) in the search field. Alternatively, search using as your search term the California Insurance Code section number of a code section that the regulations implement (for instance, "922.8"), or search by keyword ("reinsurance," for example, or "cession"). Then, click on the "Submit" button to display links to the various filing documents.

To browse, click on the "Browse All Regulations" button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear. Find in the list the "Reinsurance Oversight Regulations" link, and click it. Links to the documents associated with these regulations will then be displayed.

## **MODIFIED LANGUAGE**

If the regulations adopted by the Department differ from those which have originally been made available but are sufficiently related to the action proposed, they will be available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.